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November 19, 1999

EX PARTE

Ms. Magalie R. Salas
Secretary
Federal Communications Commission
Room TW-A325
445 12th Street
Washington, DC 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

**Re: CC Docket No. 98-137, Biennial Review -- Review of
Depreciation Requirements for Local Exchange Carriers**

**ASD 98-91, United States Telephone Association Petition for
Forbearance From Depreciation Regulation for Price Cap Local
Exchange Carriers**

Dear Ms. Salas:

On September 21, 1998, USTA filed a petition requesting that the Commission forbear from enforcing Sections 32.2000(g) and (h) and 43.43 of the Commission's rules, which address depreciation accounting and reporting, and from conducting depreciation prescription proceedings pursuant to Section 220(b) of the Act.

The Commission should deny USTA's forbearance petition because Commission-prescribed depreciation rates and methods continue to be necessary to protect the ILECs' interstate ratepayers. As the Commission stated in the Notice of Proposed Rulemaking in CC Docket No. 98-137, depreciation regulation can only be eliminated when robust competition exists in the local exchange markets.¹ Today, competition in the local exchange and exchange access markets is far from "robust." The Commission continues to regulate the ILECs as dominant carriers, and recently noted that "[c]ompetition is still

¹In the Matter of 1998 Biennial Regulatory Review -- Review of Depreciation Requirements for Incumbent Local Exchange Carriers, Notice of Proposed Rulemaking, CC Docket No. 98-137, released October 14, 1998, at ¶ 7 (Depreciation Forbearance Notice).

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in its infancy in the vast majority of local areas.”²

If the USTA petition were granted, the ILECs would have virtually unlimited ability to manipulate their reported earnings. They would, in particular, have the ability to inflate their depreciation expense by using depreciation rates higher than those currently prescribed by the Commission, and by using alternate depreciation methods. Given that depreciation expense represents approximately one-third of the ILECs’ operating expenses, the impact of such manipulation on the ILECs’ reported rate of return would be significant. At a minimum, forbearance from depreciation regulation would make the ILECs’ reported earnings useless as a tool for monitoring the performance of the Commission’s price cap regime.

The ILECs suggest that generally accepted accounting principles (GAAP) and SEC regulations would provide adequate safeguards, and argue that the shorter depreciation lives (and higher depreciation rates) that the ILECs use for financial reporting purposes are “more reflective of current market conditions and technological change.”³ But the Commission recently concluded, in the Inputs Order, that the Commission’s prescribed lives appropriately consider the impacts of technological change and obsolescence.⁴ The Commission has stressed repeatedly that the depreciation practices used for financial reporting purposes are designed to protect investors, not ratepayers. In the Inputs Order, the Commission observed that “[t]he depreciation values used in the LECs’ financial reporting are intended to protect investors by preferring a conservative understatement of network assets, partially achieving this goal by erring on the side of over-depreciation.”⁵

²Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications Corporation to WorldCom, Inc., Memorandum Opinion and Order, CC Docket No. 97-211, released September 14, 1998, at ¶ 168.

³Ameritech Comments, CC Docket No. 98-137, ASD 98-91, December 8, 1998, at 5.

⁴In the Matter of Federal-State Joint Board on Universal Service, Tenth Report and Order, CC Docket No. 96-45, released November 2, 1999, at ¶ 427 (Inputs Order).

⁵Id. at ¶ 429 (emphasis added). See also Depreciation Simplification, Report and Order, FCC 93-452, released October 20, 1993, at ¶ 42 (“GAAP is guided by the conservatism principle which holds, for example, that when alternative expense amounts are acceptable, the alternative having the least favorable effect on net income should be used. Although conservatism is effective in protecting the interest of investors, it may not always serve the interest of ratepayers. Conservatism could be used under GAAP, for example, to justify additional (but, perhaps not “reasonable”) depreciation expense by a LEC”)

Obviously, “erring on the side of over-depreciation” is not in the interest of ILEC customers who would have to pay higher rates for ILEC interstate services. And “erring on the side of over-depreciation” would also be damaging to the future development of local competition. By accelerating depreciation, the ILECs would be able to recover a greater proportion of their fiber investments and other investments incurred in anticipation of competition while they still hold overwhelming market power. If the ILECs were able to recover a disproportionate share of these investments from captive ratepayers, they would be able to unfairly underprice their services in the future. Such a strategy would frustrate competition for years to come.

USTA’s claim that over-depreciation would have no impact on ratepayers or competition is completely unconvincing. For years, the ILECs have sought to accelerate capital recovery by claiming that Commission-prescribed depreciation rates have created a “depreciation reserve deficiency” for which the Commission should create a special recovery mechanism. In its forbearance petition, USTA freely admits that depreciation forbearance is merely another step in the larger ILEC campaign to recover as much as their investments as possible from captive ratepayers through a special recovery mechanism. USTA specifically states that “[w]hen forbearance takes effect, individual price cap LECs should not be precluded from making their cases for recovery of any depreciation reserve deficiencies that may exist.”⁶

Even if the Commission did not authorize creation of a special recovery mechanism, the ILECs would still be able to increase costs for interstate ratepayers by accelerating depreciation. The Commission’s price cap plan continues to allow for above-cap tariff filings, which the ILECs could seek to justify by manipulating their reported rate of return. The price cap plan also continues to include the low-end adjustment mechanism, which the ILECs could trigger automatically by manipulating their reported rate of return to fall below 10.25 percent.

USTA seeks to downplay the possibility of an above-cap filing or a low-end adjustment, arguing that these mechanisms have been used only “rarely.” But the ILECs’ past behavior is irrelevant. If the low-end adjustment mechanism has been used only rarely, this is in large part because Commission-prescribed depreciation rates have ensured accurate and uniform reporting of ILEC earnings. Grant of the USTA forbearance petition would make it far more likely that the low-end adjustment mechanism would be used. SBC, for example, has put calculations on the record that show that Southwestern Bell could have reported a rate of return over two percentage points lower by using “financial” depreciation rates -- driving its reported rate of return well below 10.25

⁶USTA Petition at 2 n.5, 18-19.

percent.⁷ The same SBC filing showed that the reported rate of return could be even lower if SWBT chose to amortize the alleged “depreciation reserve deficiency.”⁸ A Common Carrier Bureau analysis attached to a recent letter to Congress from Chairman Kennard suggested that the likely increase in depreciation expense that would result from elimination of Commission depreciation regulation “would make nearly every price cap carrier eligible for a substantial access charge increase totaling as much as \$1.5 billion.”⁹

USTA suggests that a LEC claiming a low-end adjustment could be required to demonstrate, at the Commission staff’s request, that its depreciation practices were “reasonable.”¹⁰ No doubt, the LECs would argue that the depreciation rates they use for financial reporting purposes are “reasonable.” As discussed above, however, the depreciation rates used for financial reporting purposes are completely unreasonable from the perspective of ratepayers because the depreciation rates used for financial reporting purposes are designed to protect investors, not ratepayers.

Moreover, USTA’s suggestion that the Commission could scrutinize depreciation rates on a case-by-case basis is hopelessly impractical. It would require the review of an unknown number of ILEC depreciation filings each year in the limited time available for annual access filing tariff review. And USTA wants to deprive the Commission of the information it would need to assess whether the depreciation rates used by the ILECs were reasonable for ratemaking purposes. In its forbearance petition, USTA requested that the Commission forbear from applying Section 43.43 of its rules, which governs depreciation reporting requirements, and forbear from applying Section 32.2000(g), which, among other things, requires that the ILECs keep records of property retirements and other data necessary to evaluate depreciation rates.

In addition to inflating interstate rates and undermining local competition by accelerating the ILECs’ capital recovery, grant of USTA’s petition would have wide-ranging impacts on other Commission proceedings. Most importantly, the Commission recently concluded that the projection lives and net salvage percentages approved by the Commission in the depreciation prescription process should be used in the synthesis cost

⁷Letter from B. Jeannie Fry, SBC, to Magalie R. Salas, FCC, May 5, 1999, Attachment A, page 1.

⁸Id.

⁹Letter from William E. Kennard, Chairman, FCC, to Senator Ted Stevens, Chairman, Senate Committee on Appropriations, September 14, 1999, Attachment at 1 (Kennard Letter).

¹⁰USTA Petition at 12.

model to compute universal service support.¹¹ The Commission explicitly declined to use the projection lives advocated by the ILECs, finding that the ILECs' proposed lives could "potentially trigger[] a dramatic distortion of the estimated cost of providing supported services."¹²

The depreciation rates approved by the Commission are also essential to computing forward-looking costs for unbundled network elements (UNEs). The Common Carrier Bureau recently noted that "many of the states rely on the Commission's depreciation accounting factors to set UNE prices charged to competitors for access to the incumbents' networks."¹³ Elimination of Commission depreciation regulation would mean that "[s]tates would have little information other than the faster depreciation lives advocated by the companies, which, if adopted by the states, could result in major increases in UNE prices."¹⁴

This past summer, state regulators strongly opposed an amendment that Congress was considering that would have limited the Commission's ability to enforce the Part 32 accounting rules, including the depreciation rules. Many of the state commissions participate in "three-way meetings" with the Commission and ILECs, and prescribe depreciation parameters for intrastate ratemaking which generally agree with those prescribed by the Commission. Indeed, some state commissions lack the resources to independently evaluate LEC filings and rely heavily upon the Commission's expertise and determinations.

The Commission should deny USTA's forbearance petition because it fails to meet the three tests outlined in Section 10(a) of the Act. *First*, continued enforcement of the Commission's depreciation prescription provisions continues to be necessary to ensure that interstate rates are just and reasonable. Absent depreciation regulation, the ILECs could manipulate their reported rate of return in order to trigger the low-end adjustment mechanism or to justify claims for an above-cap filing.

Second, continued enforcement of the Commission's depreciation prescription provisions is necessary to protect consumers. Erroneous triggering of the low-end adjustment mechanism would decrease consumer welfare by increasing interstate access charges. Consumers would be harmed by higher end user charges and by higher long distance rates, which would suppress demand for long distance calling.

¹¹Inputs Order at ¶¶ 425-431.

¹²Id. at ¶ 428.

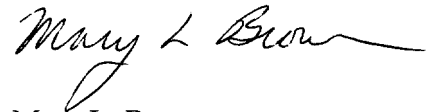
¹³Kennard Letter, Attachment at 2.

¹⁴Id.

Third, forbearance would not be in the public interest. In addition to increasing interstate access rates, forbearance would open the door to higher UNE rates and allow the ILECs to recover a disproportionate share of investments from captive ratepayers. Forbearance from depreciation regulation would also risk substantially increased universal service support costs.

To the extent that the Commission finds that any modification to the current depreciation rules is necessary, the proper approach is for the Commission is to continue with the depreciation simplification process started in the CC Docket No. 98-137 Biennial Review proceeding. In that proceeding, the Commission has proposed a substantial reduction in the filing requirements imposed on the ILECs, from today's requirement of approximately 170 pages to only 4 summary exhibits.¹⁵ This proposal would result in significant industry and Commission savings without diminishing the effectiveness of the Commission's oversight.

Sincerely,

A handwritten signature in cursive script that reads "Mary L. Brown". The signature is fluid and elegant, with a long horizontal flourish extending to the right.

Mary L. Brown

cc: Larry Strickling
Ken Moran
Andy Mulitz
Tim Peterson
Dorothy Attwood
Linda Kinney
Rebecca Beynon
Sarah Whitesell
Kyle Dixon

¹⁵Depreciation Forbearance Notice at ¶ 10.